

House Financial Services Committee Hearing "Beyond the Tax Cut: Unleashing the Economy"
March 29, 2001

Statement by:

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Mr. Chairman, I am pleased and honored to have the opportunity to testify before the committee on the issues of tax policy and capital formation and to submit these written comments. This hearing could not come at a more propitious time given the current challenges our economy faces in the area of capital formation. Weakening economic performance and a greatly devalued stock market have significantly inhibited, and will further erode, the ability of our capital markets to allocate the necessary resources to fund growth in our economy and maintain our international competitiveness.

I am a General Partner at Kleiner Perkins Caufield & Byers in Menlo Park, California; we are a high technology venture capital firm, and, in that capacity, I serve on the board of directors of seven high technology companies. I also serve as Chairman of Empower America, a Washington based issue advocacy organization; on the board of the Washington based National Venture Capital Association and on the Executive Committee of the Technology Network, a network of about 280 high technology firms with headquarters in California but with members from across the country. My testimony today, while influenced by each of these associations, represents, however, my personal view on steps that could unleash the economy.

Mr. Chairman, as you know, the venture capital industry has been a catalyst for much of our economy's remarkable and consistent growth in the past decade. My colleagues and I have invested in the ideas and people that have fundamentally changed our economy and the ways in which we live and work. We have provided the necessary capital, mentoring and guidance to help high growth companies realize their potential in the burgeoning areas of information technology, telecommunications, biotechnology, the Internet, and beyond.

The growth our industry has experienced during this time has been nothing short of superlative. What used to be a relatively small, regionally based community of investors has expanded into a large, nation-wide industry. The skills of talented entrepreneurs and managers backed by venture professionals has translated into successful investments that have greatly increased interest among the investing community in this asset class and has provided significant returns to the pension funds, foundations, university endowments and other organizations that are our limited partners.

These investments do not merely build high growth companies, they are helping to introduce and integrate critical technological innovations that are being applied everywhere in the economy. According to recent studies published by the Federal Reserve Board, the application of information technology throughout industry over the past decade has vastly increased labor productivity. The abstract of a Board paper entitled, "The Resurgence of Growth in the Late 1990s: Is Information Technology the Story?" succinctly makes the case:

"The performance of the U.S. economy over the past several years has been remarkable, including a rebound in labor productivity growth after nearly a quarter century of sluggish gains... Our results indicate that the contribution to productivity growth from the use of information technology — including computer hardware, software, and communication equipment — surged in the second half of the 1990s. In addition, technological advance in the production of computers appears to have contributed importantly to the speed-up in productivity growth. All in all, we estimate that the use of information technology and the production of computers accounted for about two-thirds of the 1 percentage point step-up in productivity growth between the first and second

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halves of the decade. Thus, to answer the question posed in the title of this paper, information technology largely is the story."

I am very proud of the role my industry has played in this story. Today, however, we are presented with the challenging question of how to keep this engine of productivity and economic growth going. As such, I am pleased to offer my comments on what steps can be taken to help entrepreneurs and others in industry to continue to innovate and build our economy.

An important first step to economic growth is already being taken. President Bush's tax relief proposal, which is advancing through Congress, is critically important to both the short-term and long-term growth of our economy. Reductions in marginal tax rates and the elimination of both the estate tax and marriage penalty will release much needed capital into the economy and lead to still greater productivity. I applaud the steps you and your colleagues are taking to enact the President's tax package.

Once the President's tax relief proposal is enacted, I strongly urge you to consider more comprehensive tax and regulatory reform effort focused on sustained economic growth and security. Below, I offer some of my specific thoughts:

Access to Capital:

The number one priority of emerging growth companies is and always has been sufficient and efficient access to capital. Congress has taken important steps in the recent past to help in this area, most recently in 1997 when it lowered the capital gains tax rate. Our industry believes that further efforts to lower the tax rate are necessary to the long-term health of our economy and international competitiveness. U.S. investors (who are now half of U.S. households) face capital gains tax rates on both short- and long-term gains, which are among the highest in the industrial world. While long-term gains for individuals are taxed at a top federal rate of 20 percent in the United States, the average tax rate in the other countries is only 14.8 percent. The short-term capital gains rate differential between the United States and its competitors is even greater: individual U.S. investors face a top federal rate of 39.6 percent compared to an average of only 18.4 percent overseas. Closing these differentials will significantly enhance the incentive within our country to buy, hold and sell equity instruments for individuals and corporations.

Interestingly, if the past is any predictor of the future, every time the capital gains rate has been reduced, revenues from taxation of capital gains have increased. Capital gains tax relief would also increase worker productivity and allow wages to rise without inflation. Finally, capital gains relief will raise the after tax return on capital making it more attractive for people to invest in start-up companies, which fuel economic growth and innovation.

In contrast to this focus on capital formation, I'm advised that there, unfortunately, appears to be some support for a \$60 billion cash-tax rebate check that is unconnected to more comprehensive reform. There is substantial evidence from experts that one time tax cuts do not substantially help an economy. The cash-tax rebate plan is aimed at temporarily bolstering consumer spending. But as ING Barrings Chief Economist Larry Kudlow points out, personal consumption expenditures are the strongest part of today's economy. For example, in the current quarter, for which real GDP will be reported in late April, real consumer spending could rise by 3.25%. In stark contrast stands investment spending, in the form of diminished stock-market purchases and business equipment expenditures, which has declined substantially pulling down the entire economy.

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As a result, we should focus on increasing capital investment as a means of restoring the economy to health. Far preferable to any kind of rebate would be for Congress to provide a front-loaded acceleration of the across-the-board marginal tax rate reductions to January 1, 2001 as proposed by the President.

On a smaller but more immediate scale, small business access to capital can also be enhanced through a regulatory clarification that will fully implement legislation Congress passed several years ago. Section 1045 of the Internal Revenue Code allows taxpayers other than corporations that dispose of qualified small business stock (QSBS) (as defined in section 1202) held more than six months to defer tax on the sale of those assets if they invest the proceeds in other QSBS within 60 days of that disposition. In 1998, Congress amended Section 1045 to make clear that taxpayers holding stock through a partnership could qualify for the benefits of that provision.

Unfortunately, Section 1045 is silent regarding how partners can obtain rollover benefits in the context of a variety of very common transactions involving partnerships. For example, virtually all venture managers and most venture investors hold partnership interests in a number of venture capital partnerships. No guidance is available, however, with regard to how a partner's share of gains attributable to one partnership's disposition of QSBS can be rolled over if another partnership, to which that partner has contributed capital, makes a timely investment in other QSBS. Issuing regulations will fulfill Congress' legislative intent and increase access to capital by our high growth companies.

Encouraging Savings:

Congress and the president could pass positive pro-growth tax relief such as increasing the limits and lift the caps on IRAs, Roth IRAs and 401(k) retirement accounts. That is a better way for America to save than by running huge and persistent budget surpluses.

Regulation of High Tech & Biotech Industry:

Congress should remain ever vigilant to guard against the growing regulatory morass that is encroaching on the high tech and biotech industries. This concern applies to a number of fronts from rules on communications technology that were developed in another age to the arcane manner in which export licenses must go through as many as five agencies to gain approval.

It is critical for policy makers to realize that the strength of our high tech and biotech sectors lies in their ability to be flexible in responding to changing technology and market conditions. With product life cycles becoming ever shorter, issues of importance to these sectors arise quickly and demand immediate attention. Because of its slow moving nature, government policy-making simply is not equipped to respond to many of these concerns in a timely fashion. Often times, a late or misguided government response will do much more harm than good.

Excessive regulation of any particular industry increases the investment risk and thereby lowers that industry's access to adequate capital. I would urge Congress to respond to industry concerns regarding unnecessary and inhibitive regulations that serve little or no purpose other than to lessen the efficiency and competitiveness of our high tech and biotech sectors in the global marketplace. It is important to remember that the American high tech industry leads the world in virtually every area of competence and produces nearly half of its revenue from export sales to the further benefit of the American economy. To my knowledge, there is no such thing as a high-growth regulated industry. Continued leadership for American companies could be threatened if regulations restrict the freedom of action that the industry has enjoyed to date.

Other Issues of Importance:

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Congress will play a key role on many other issues that will affect the growth of the high tech and biotech sectors and the expansion of our economy. In order to assure that these sectors are financially healthy and have adequate access to capital, I would urge Congress to pursue pro-growth policies in the following areas:

- Free trade: open and fair access to foreign markets is critical to the success and growth of these sectors. As just mentioned, the average annual export sales as a percentage of revenue for a typical venture-backed company grows from zero to 43 percent in the early years of the company's life. In order to expand these overseas opportunities for growth, our industry strongly supports extending Trade Promotion Authority to President Bush.
- Efficient stock markets: secure, flexible and efficient stock markets are essential for high growth, venture-backed companies to grow to the next level after the venture capitalist exits his or her investment in the company.
- Effective patent and copyright protection: intellectual property is the lifeblood of venture-backed high tech and biotech firms. Secure protection of IP rights is prerequisite for investment in a start-up. Assuring an efficient and equitable patent and copyright processing system is a priority.
- Workforce/education issues: access by venture-backed firms to skilled and well-trained workers is critical to the success of these companies. Investment decisions are often made in part on the basis of an entrepreneurial firm's line-up of managerial and technical talent. Thus, our industry commends Congress for increasing the availability of H-1B visas last year. At the same time, we recognize the great need to reform our education system and we look forward to working with President Bush and Congress on the education proposals and workforce training legislation that will advance educational opportunities for all Americans. The fact that we need 195,000 H-1B workers while our universities are graduating only some 45,000 engineers per year points to the dramatic need for education reform.
- Congress could eliminate the three-year write-off period for software and allow companies to expense the cost of software immediately; make permanent the R&D research tax credit; and cut taxes that pose as obstacles to broadband deployment and the productivity gains it would produce.

The President's plan, along with these pro-growth tax initiatives and a cooperative monetary policy will help stimulate the economy and set the stage for the next phase in the president's economic plan. After getting the economy back on a growth trajectory, the president will be free to provide a comprehensive vision for the future of the American economy.

The vision would essentially consist of the reforms President Bush has already articulated. The administration and congress should forge ahead as quickly as possible to reform Social Security into a payroll-tax-financed worker-investment and personal retirement account program by allowing workers to invest a significant portion of their payroll taxes into personal retirement accounts.

Again, I am honored and pleased to be before your committee to discuss these vitally important issues. Although there is much work still to be done to implement the President's tax relief package, I commend you for your leadership in beginning the discussion of the next steps to be taken in order to enhance our economy's growth and efficiency.